

THE MUNICIPAL TAX WORK GROUP
REPORT OF THE DEPARTMENT OF REVENUE

November 2001

Background

Thirty-seven cities in Washington impose a business and occupation tax on the gross receipts of businesses. In 1999, cities collected more than \$190 million in business and occupation tax. On average, business and occupation tax made up almost twelve percent of the operating revenue of cities that had the tax.

For several years, the business community has expressed concerns about city business and occupation taxes. Major concerns include the lack of uniformity among the cities' tax systems and multiple taxation of the same income by two or more cities. In the past two legislative sessions, the business community has supported legislation that would require cities to have definitions and classifications identical to those in the state business and occupation tax.

The cities have acknowledged the concerns expressed by business. A group of cities that have business and occupation taxes have worked toward a more uniform system by developing a model ordinance to be adopted by all cities having these taxes. The model ordinance has definitions and classifications that are similar to, but not identical with, the state business and occupation tax. The model ordinance also eliminates the possibility of two or more cities taxing the same income.

Some parts of the model ordinance, including the definition of nexus, administrative provisions, and credits and deductions to avoid multiple tax burdens, would be mandatory for all cities. Other parts would serve as a base for city taxation, but individual cities could take exceptions to these provisions. The model ordinance and all exceptions would be readily available to businesses in paper and electronic form.

The cities are concerned about local control of their own finances and think that linking their tax systems to the state's would entail a significant loss of local control and the flexibility to deal with unique local conditions.

Through last spring, the cities and the business community had not been able to develop a mutually satisfactory resolution to these issues. In May, Governor Locke asked Fred Kiga, Director of the Department of Revenue, to convene a working group of city and business leaders to work toward a solution. Attachment I is the Governor's memorandum to Director Kiga on this subject. In the memorandum, the Governor expressed his belief that having healthy cities and a robust business climate are too important to let this problem go unresolved. He validated both the business community's concern about the lack of uniformity and the cities' concerns about local control and flexibility. His charge to the working group, known as the Municipal Tax Work Group (See Attachment II for a list of participants), was to arrive at recommendations

for a solution to municipal gross receipts taxation. If the group could not agree, the Department of Revenue was to make its own recommendations.

Issues addressed by the Municipal Tax Work Group

The Work Group began formal meetings in August and met almost weekly through mid-October. Using the Governor's charge as a starting point, the dialogue was framed in terms of certain attributes that speak to the concerns of the parties and that should be incorporated into a better system of municipal gross receipts taxation:

- Uniformity
- Local control
- Revenue neutrality
- Simplicity
- Fairness
- No multiple taxation

The discussion that follows is the Department of Revenue's sense of the issues covered by the Work Group and the positions taken by some of the participants. No votes were taken. Not all participants were at every meeting. This discussion summarizes the views that were expressed and does not necessarily reflect the positions of either the business community as a whole or all cities.

Issue: Should the tax base, classifications, exemptions, deductions, and credits be uniform?

Attributes: uniformity, local control

Some business representatives originally wanted uniformity with the state business and occupation tax system. These business representatives thought there should be variation only in limited circumstances where there is verifiable, undue financial hardship for a majority of cities. Later in the process, a business representative suggested that only certain core definitions from the state business and occupation tax should be required and that cities would be able to establish subclassifications under the core definitions.

The city representatives were willing to have adoption of the model ordinance required within four years with uniform definitions among all cities within eight years. The tax structure would be uniform among the cities and would be similar to, but not identical with, the state business and occupation tax. The cities would allow deviations to address unique local circumstances. Deviations could include additional definitions and different classifications, exemptions, deductions, and credits.

There was no agreement as to the tax base and classifications. However, there was support for the idea that cities should be free to adopt whatever exemptions, deductions, and credits that would be appropriate for local circumstances.

Issue: Allocation/apportionment of income.

Attributes: revenue neutrality, fairness

Some business representatives wanted a system similar to the state's business and occupation tax treatment of interstate transactions. Cities could tax activities taking place within the city, but would not be able to tax activities occurring outside the city. The place of sale for wholesaling and retailing would be determined using the rules for local sales tax. The tax would be apportioned for service activities. Some city representatives objected to the business proposal because a system similar to the state's would result in no tax on activities taking place outside of business and occupation tax cities, even if there was nexus.

The cities' model ordinance would tax activities if there was nexus with a city and no other city imposed a tax on the activity. If there was nexus for two or more cities to tax an activity, a system of priorities would be established. The first city in priority is the city of destination of the goods or the performance of the service. If that city did not impose a business and occupation tax, then the customer location city could impose its tax. If the customer location city did not impose a business and occupation tax, the city of the seller/provider could impose its tax. However, a city representative stated that under current practice, sales made from a physical retail location not in a city imposing a business and occupation tax would not be subject to tax. The representative indicated that it was not the intent for the model ordinance to change this practice.

There was no agreement on this issue. There is no currently available data that accurately quantifies the impact of the business proposal or other alternatives for allocation and apportionment that might be considered.

Issue: How is nexus to be defined?

Attributes: uniformity, revenue neutrality, simplicity, fairness

Some representatives of the business community wanted to use the same standards applicable to the state business and occupation tax.

The cities, in the model ordinance, identified bright line tests for levels of activity, including the amount of time spent in a city, that would create nexus. Some city representatives suggested that if a business generated a certain level of gross income, in addition to having the requisite type of activity, without floors on the amount of time spent in a city, nexus would exist.

Representatives of small business expressed interest in the city proposal for using a threshold income amount as part of the nexus standard. Other representatives of business also were interested in this proposal, but expressed concern that in-state businesses would be subjected to lower nexus requirements than out-of-state businesses. One city representative stated that there was no intent to treat in-state and out-of-state businesses differently.

Issue: Should head taxes and square footage taxes be credited against gross receipts taxes?

Attributes: revenue neutrality, simplicity, fairness, no multiple taxation

The business community originally said yes, the cities said no.

Business agreed to take this issue off the table.

Issue: Should software development be included in the definition of manufacturing?

Attributes: uniformity, local control, revenue neutrality, simplicity, fairness

Business representatives said it is not consistent with the state definition and should not be included.

Some cities originally wanted software in the definition, subject to the ability of cities to exclude it. Later in the process, a city representative who was a major proponent of this position agreed that software development would be excluded from the definition of manufacturing in the model ordinance. Instead, some cities may pursue exceptions to the model ordinance to provide some form of taxation for software development. In the case of Seattle, there will be an offsetting credit for research and development.

There appeared to be agreement on this issue.

Issue: Should the model ordinance be mandatory?

Attributes: uniformity, local control, simplicity, fairness

At the beginning of the process, business representatives agreed to use the cities' model ordinance as a vehicle for discussion, but did not commit to it as a solution.

In that context, business and the city representatives agreed that adoption of an agreed-to ordinance should be mandatory. Some business representatives were willing to consider a phase-in period of two to three years. Some city representatives proposed adoption within four years with uniform definitions within eight years.

Issue: How are revenue impacts to be dealt with?

Attributes: local control, revenue neutrality

Business representatives believed that revision in municipal taxes should not result in increased taxes. However, they were willing to consider methods to mitigate verifiable revenue impacts for individual cities. They suggested that allowing subclassifications with special rates and removing the cap on rates without a public vote would be ways to mitigate revenue loss. They also suggested that a period to phase in a new system could be used.

City representatives believed that the Legislature would be unlikely to give cities the authority to raise rates without a public vote. Even without a public vote, city councils would probably be unwilling to raise rates. City representatives also expressed concern that raising rates would shift the tax burden from businesses who operate among numerous jurisdictions to those that operate exclusively within a business and occupation tax city.

This issue was unresolved.

Issue: Duration of business licenses.

Attributes: simplicity, fairness

Business and the cities agreed that cities should be able to issue business licenses for periods longer than one year. Under current law, they cannot.

Areas of agreement and disagreement

The parties appeared to agree on the following:

- No credit should be given for dissimilar taxes paid to other jurisdictions.
- Software development should not be in the definition of manufacturing.
- Provisions for city business and occupation taxes should be mandated in state law.
- Limits on the duration of business licenses should be removed.
- Activities taxed under city utility taxes should continue to be so taxed.
- There should be no multiple taxation of income.
- Nexus provisions should comply with Commerce Clause standards.

There did not appear to be agreement on the following:

- Uniformity with state business and occupation tax provisions.
- How to allocate and apportion income.
- How to deal with revenue impacts of a changed city business and occupation tax structure.
- How long cities would have to adopt new mandatory provisions.

Recommendations

- The Department of Revenue recommends that legislation be introduced in 2002 imposing requirements on any city imposing a business and occupation tax.

Representatives of both the cities and the business community agreed that changes in the city business and occupation tax structure should be mandated in state law. This will provide uniformity among the cities in apportionment, nexus, administrative provisions, and preventing multiple taxation.

- Cities imposing business and occupation taxes must comply with all requirements within three years of the effective date of state legislation imposing the requirements.

Representatives of both the cities and the business community agreed that there should be some period of time before mandatory adoption to plan for the changes. City representatives proposed four years to adopt a model ordinance and eight years to adopt uniform definitions. The additional time requested by the cities was to allow time to adjust for revenue losses that might be caused by conforming to the changes. Some business representatives suggested two to three years for full adoption.

- Activities taxed by cities as utilities prior to the effective date of the state legislation should continue to be taxed under city utility taxes.

Business representatives participating in the Work Group and the cities agreed that cities should be allowed to continue to tax these activities as utilities. The revenue loss to cities from taxing activities such as telephone service under the business and occupation tax would be very large at the current rates.

- Multiple taxation of the same income should be eliminated through a uniform system of credits.

Representatives of both the cities and business agreed that there should be no multiple taxation of the same income earned by one business performing different taxable activities. For example, a business manufacturing an article in one city and selling that article in another city should not have to pay tax on the selling price of the article to both cities. This recommendation accomplishes this through the mechanism of a credit. The credit system is what is used at the state level and is what was sought by the cities.

- Uniform definitions conforming to those in the cities' proposed model ordinance should be adopted to the extent necessary to implement a system of credits to eliminate multiple taxation.

Representatives of the business community wanted definitions identical to the state definitions. These definitions would change as the state definitions change over time. City representatives wanted definitions similar to, but not identical with, the state definitions. The cities' concern was loss of local control, and especially reductions in the tax base, due to changes that might be instituted by the Legislature if the definitions were tied to the state business and occupation tax. The parties agreed that at least some definitions should be uniform, but did not agree on how to achieve uniformity.

- A business should not be subject to tax by a city unless it had both nexus under Commerce Clause standards with the city and it received a threshold amount of gross income from taxable activities in the city.

Representatives of both cities and business agreed to this. Nexus would be the same for interstate and intrastate activity.

- Cities should be free to adopt any exemptions, deductions, and credits they choose.

Representatives of both business and cities agreed on this point. This promotes local control by allowing cities to adapt their tax structure to local conditions.

- City business and occupation taxes should be identical to the state business and occupation tax with respect to due dates, penalties, interest, and statutes of limitation.

Representatives of both business and cities agreed that the administrative provisions should be uniform among the cities. Consistency with the state provisions promotes simplicity and uniformity. It also eases the administrative burden on businesses.

- Cities should be given the authority to issue business licenses for more than one year at a time.

Although this is outside the scope of the work group, the subject did come up and all parties agreed with this recommendation. This will simplify the licensing process and decrease costs for both businesses and cities.

- The Department of Revenue recommends that it continue working with the parties to develop policy options in the area of allocation and apportionment of income. These options would be presented for the Governor's consideration prior to the 2003 legislative session.

In particular, the Department will, with the cooperation of all parties, quantify the impact of various alternatives to the allocation and apportionment of income and also of alternatives for dealing with revenue impacts.

Attachments (2)